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The anatomy of Holding Foreign Companies Accountable Act (HFCAA): a panacea or a double-edge sword?

Qingxiu Bu^{*}

Key points

- Accurate financial statements are critical to investors in making informed decisions and vital to the overall well-being of the US capital market.
- For cross-listed and multi-jurisdictional businesses, the current regulatory frameworks fail to create governance equivalency between foreign and US domestic issuers that are listed in the USA.
- The US Holding Foreign Companies Accountable Act (HFCAA) seeks to level the playing field.
- Companies that use accounting firms which cannot be inspected by the Public Company Accounting Oversight Board for three consecutive years risk being de-listed from US securities exchanges and also becoming subject to a prohibition in over-the-counter trading in their stock.
- Behind the statutory response in HFCAA are intertwined tensions between stakeholders and sovereigns.
- The key to addressing the current imbalances will be to strike a balance between maintaining the US stock markets' open to high-quality foreign issuers and enabling US investors to have access to reliable financial information.
- It remains uncertain whether the HFCAA will reshape the governance landscape geoeconomically.

1. Introduction

The bedrock of the US stock market system is high-quality and reliable financial statements.¹

The USA remains a paramount listing location due to the integrity and consistency furthered by regulations aimed at protecting investors in its markets. Foreign companies have long been attracted by the markets' efficiency and liquidity as well as the potential benefits offered in the form of brand-name enhancement and increased visibility.² Contributing factors include the US disclosure requirements, efficient regulatory oversight and enforcement, and strong financing capacity.³ Listing in the USA also gives start-ups

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¹ Sagar Teotia, *Statement on the Continued Importance of High-Quality Financial Reporting for Investors in Light of COVID-19* (US Securities and Exchange Commission 2020). <<https://www.sec.gov/news/public-statement/teotia-financial-reporting-covid-19-2020-06-23>> accessed 10 August 2021.

² Jay Clayton, Wes Bricker and William Duhnke, III, 'Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally' (Washington DC, SEC and DoJ, 7 December 2018) <<https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other>> accessed 10 August 2021.

³ John C Coffee, Jr, 'Racing towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance' (2002) 102 (7) Columbia Law Review 1757, 1831.

new access to foreign investors and additional credibility. A large number of Chinese companies cross-list in the USA via a variable interest entity (VIE), seeking to establish a reliable trading presence for their securities.⁴ The investment legal vehicle enables them to hold a controlling interest despite the dearth of the majority of voting rights. Their operating entities are primarily based in China, where the audit work is also carried out by local accounting firms. There have long been concerns about the quality and independence of the audits and financial information of US-listed Chinese companies (ULCCs).^{5,6} Although VIEs are mostly used for legitimate business purposes, inadequate governance in this area allows some companies to manipulate their financial statements to hide losses and fabricate earnings.⁷ US regulators, such as the Public Company Accounting Oversight Board (PCAOB), are not allowed to inspect the work and practices of audit firms based in China, making it harder to discern whether the financial statements reflect a ULCC's true financial position. Given this institutional void, ULCCs are not subject to the same regulatory oversight as other companies that trade on US exchanges, resulting in a situation where there is a double-standard in regulation.

This study proceeds into four parts. Section 2 starts with the *Luckin Coffee* scandal, which puts the spotlight on these governance issues with ULCCs. The significance of reliable financial statements cannot be overstated for the capital markets, which depends on high-quality audit services and effective regulatory oversight. Section 3 looks into the current unviable *de facto* two-tier compliance system under which Chinese issuers are subject to a double-standard inspection. The PCAOB is not allowed to inspect those ULCCs' audit papers, and the legal recourse for investors is limited. The conferral of extraterritorial jurisdiction on the PCAOB would pave the way to allowing it to discharge its inspection duties. Section 4 discusses the Holding Foreign Companies Accountable Act (HFCAA), which was enacted to delist firms that are out of compliance with US audit oversight requirements for a period of 3 years. HFCAA could inevitably put the ULCCs in a precarious position of trying to comply with conflicting laws in the two jurisdictions. It is worth exploring whether HFCAA, potentially a nuclear option, is viable as an effective deterrent against fraud. Section 5 seeks to break the deadlock, exploring potential routes to address the cross-border challenges of securities governance and financial oversight. A concluding remark is provided, highlighting that multipronged approaches will help to mitigate the problem in the current confronting environment.

4 Donald Clarke, 'The Bonding Effect in Cross-Listed Chinese Companies' in Robin Hui Huang, Nicholas Howson and Robin Huang (eds), *Enforcement of Corporate and Securities Law* (Cambridge University Press 2017) 88–100.

5 Harry Broadman, 'Forced U.S.–China Decoupling Poses Large Threats' *Forbes* (Forbes, Inc., 30 September 2019).

6 James P Naughton and others, 'SEC Monitoring of Foreign Firms' Disclosures in the Presence of Foreign Regulators' (2018) 23 *Review of Accounting Studies* 1355, 1388.

7 Li Guo, 'Chinese Style VIEs: Continuing to Sneak Under Smog?' (2014) 47 *Cornell International Law Journal* 569, 580.

2. The scandal of Luckin Coffee

Investors are generally enticed by the massive market potential of China, while capital markets do not function well without reliable financial information.⁸ Many ULCCs adopt VIE and dual-class stock structures, which entails further governance risks with instances of significant losses for investors.⁹ The SEC and the PCAOB face significant challenges in overseeing ULCCs' auditing papers due to their complex cross-border operation.¹⁰ In addition, China's intransigence in allowing PCAOB access to those papers renders it nearly impossible for the US investors to have a true picture of the financial health of those companies.¹¹ This issue has been put in the spotlight in the wake of Luckin Coffee's implosion, a fraud which has caused investors to lose billions of US dollars. More problematically, investors have limited legal resources to hold those China-based perpetrators accountable.¹² As such, companies with primary operations in China that have been listed or intend to be listed in US stock exchanges are increasingly coming under scrutiny.

Luckin Coffee's systematic fraud

The coffee chain Luckin is the China-based equivalent of Starbucks, and uses data analytics and artificial intelligence (AI) to improve its operations. Listed on the NASDAQ stock exchange in May 2019, Luckin Coffee has benefited from reduced cost of capital, increased liquidity and increased visibility after cross-listing in the USA. It has attracted high-profile investors, like Credit Suisse, Morgan Stanley, Blackrock and Singapore's sovereign-wealth fund Government Investment Corporation (GIC).

In the bull market, Luckin Coffee adopted novel metrics that flattered performance.¹³ In order to support its rapid expansion plans, Luckin Coffee is reported to have fabricated over ¥RMB 2.2 billion (\$280 m) in sales for April up to December of 2019.¹⁴ Deploying the metrics to enhance investor confidence, Luckin Coffee is reported to have evolved into a systemic fraud by fabricating financial and operating numbers, right after its \$645 million IPOs.¹⁵ About US \$11 billion in wealth vanished, causing significant losses for many investors and wiping out billions of dollars of shareholder wealth. Trading in the

8 James Ang, Zhiqian Jiang and Chaopeng Wu, 'Good Apples, Bad Apples: Sorting among Chinese Companies Traded in the US' (2016) 134 (4) *Journal of Business Ethics* 611, 629.

9 Paul Gillis, 'Testimony before the U.S.–China Security and Economic Commission' (Washington DC, USCC, 28 February 2019) <<https://www.uscc.gov/sites/default/files/gillis%20feb%2028%202019%20testimony.pdf>> accessed 10 August 2021.

10 Michelle Lowry and Paul Gillis, 'Son of Enron: Investors Weigh the Risks of Chinese Variable Interest Entities' (2014) 26 (3) *Journal of Applied Corporate Finance* 61, 66.

11 Marco Rubio, 'You Can't Trust a Chinese Audit; A New Bill would Ensure that U.S.-Listed Companies Comply with American Financial Reporting Rules' *The Wall Street Journal* (Almar Latour, 4 June 2019).

12 Helen Raleigh, 'Coronavirus Exposes Another Chinese Scandal: Rampant Corporate Fraud' *The Federalist* (Ben Domenech, 13 April 2020).

13 'Who's Lost Their Trunks?' (2020) 435 (9190) *The Economist* 49, 50.

14 Ibid.

15 Dave Michaels, 'SEC Investigates China's Luckin Coffee over Accounting Scandal; Probe will be a Test of the SECs Ability to Obtain Information from Abroad' *The Wall Street Journal* (Almar Latour, 29 April 2020).

company's shares was halted on 6 April 2020 and it was delisted by NASDAQ on 29 June 2020.¹⁶ Luckin Coffee's shares traded on the NASDAQ until 13 July 2020, and the company has agreed to pay a \$180 million penalty to settle accounting fraud charges with the SEC.¹⁷ The scandal marks the worst crisis in confidence for 'China Inc.' and shakes the faith of investors in ULCCs' corporate governance and financial oversight.¹⁸ It is, however, far from the first time that a US-listed Chinese company has been embroiled in allegations of accounting manipulation.¹⁹ Luckin Coffee's accounting scandal is underscoring concern over lax corporate governance and financial oversight and putting the spotlight on ULCCs' malpractice.

Investors have filed a number of lawsuits against fraud at Luckin Coffee for alleged violations of the Securities Exchange Act of 1934.²⁰ It was alleged that the firm had made false statements, and failed to disclose:

- (i) that certain of Luckin Coffee's financial performance metrics, including per-store per-day sales, net selling price per item, advertising expenses and revenue contribution from 'other products' were inflated;
- (ii) that Luckin Coffee's financial results thus overstated the Company's financial health and were consequently unreliable; and
- (iii) that, as a result, the Company's public statements were materially false and misleading at all relevant times.²¹

Luckin Coffee has faced devastating consequences that went beyond merely being delisted by NASDAQ. This fraud led to Luckin Coffee paying hefty compensation that has resulted in its bankruptcy. Luckin Coffee's collapsing fortunes means losses for investors who invested in the Company's 2019 IPO on NASDAQ.²² The SEC's ability to thoroughly investigate the reported misconduct at Luckin Coffee depends on how much information is shared by Chinese regulators, such as the China Securities Regulatory Commission (CSRC) and the State Administration for Market Regulation (SAMR), who have been staging their own probe.²³ However, the US regulatory and judicial agencies face challenges in enforcing actions against the Company and its directors. One activity of enormous significance is for the US authorities to explore potential legislative reform that can be taken to mitigate the risk of similar situations from happening.

16 Jing Yang, 'Luckin Coffee Drops Nasdaq Appeal; Shares to Be Delisted' *The Wall Street Journal* (26 June 2020).

17 Alistair Gray, 'Luckin Coffee to Pay \$180m in Accounting Fraud Settlement' *Financial Times* (16 December 2020).

18 Jeffrey Mahoney, 'Inspection of PCAOB-Registered Chinese Auditor' (Harvard Law School Forum on Corporate Governance, 17 April 2020) <<https://corpgov.law.harvard.edu/2020/04/17/inspection-of-pcaob-registered-chinese-auditor/#5>> accessed 10 August 2021.

19 Nisha Gopalan, 'Investors Wake Up and Smell the Luckin Coffee' *The Washington Post* (3 April 2020).

20 Quentin Webb and Joanne Chiu, 'Ernst & Young Says It First Found Accounting Issues at Luckin' *The Wall Street Journal* (3 April 2020).

21 'Luckin Coffee Shareholder Notice: Faruqi & Faruqi, LLP Encourages Investors Who Suffered Losses Investing in Luckin Coffee Inc' *Bloomberg* (4 April 2020).

22 Jing Wang, 'Banks Stand to Lose More Than \$100 Million on Loan to Chairman of China's Luckin Coffee' *The Wall Street Journal* (6 April 2020).

23 Michaels (n 15).

Repercussion on ULCCs and potential IPOs

The Luckin Coffee debacle has turned the spotlight back on the accounting risks faced by investors in ULCCs.²⁴ Fraud allegations for one China-based company led to investors penalizing other China-based companies' stock prices, resulting in a spillover effect.²⁵ The Luckin case has a knock-on effect on other ULCCs as the scandal heightens long-standing worries over accounting standards at such companies.²⁶ Constraints on oversight raise company-specific risk, which not only increase uncertainties, but also have broad confidence-related effects. It will inevitably affect the investors' confidence and market momentum on other ULCCs.²⁷ The scandal has tarnished their integrity and diluted trust by international investors. In the US regulators' eyes, Chinese companies remain a particular risk, which has led to increased SEC scrutiny of China-based issuers.²⁸

The US regulators seek to implement a higher threshold for companies that wish to access capital markets. In response to the paramount challenge of auditor quality, the PCAOB was established under Sarbanes–Oxley Act of 2002 and is overseen by the SEC.²⁹ It is tasked with policing the accounting firms that sign off on the books of the US-listed companies.³⁰ There should be a price for disregarding the rules of responsible financial engagement. Those ULCCs that do not make their audits available for PCAOB review will be subject to increased disclosure requirements. The market for Chinese IPOs in the USA is bound to suffer. The Luckin fraud undermines confidence more broadly, which will affect potential US IPOs from China.³¹ It has disrupted dozens of IPOs, intensifying investor concerns about the amount of trust they can place in audited financial results in China. The situation underscores the tension underlying Chinese companies looking to list on US exchanges, which are set to face substantial challenges and much tighter scrutiny. As a matter of fact, PCAOB has re-evaluated its approach to new registration applications from firms in China, and legislators have considered imposing further restrictions on Chinese access to US listing opportunities. The new rules would require higher accountability standards to qualify for listing. With tightened listings rules, the US stock exchanges are also trying to curb IPOs of Chinese companies closely held by insiders and which are opaque about accounting.³²

24 Hudson Lockett, Thomas Hale and Henny Sender, 'Luckin Debacle Shakes Investor Faith in New York's China Listings' *Financial Times* (12 April 2020).

25 Masako N Darrrough, Rong Bing Huang and Sha Zhao, 'Spillover Effects of Fraud Allegations and Investor Sentiment' (2020) 37 (2) *Contemporary Accounting Research* 982–1014.]

26 Lockett (n 24).

27 Jeanny Yu, Vinicy Chan and Daniela Wei, 'Luckin Coffee Scandal Deals New Blow to Corporate China' *Bloomberg* (3 April 2020).

28 Jay Clayton and others, 'Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited' (Washington DC, SEC, 21 April 2020) <<https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting>> accessed 10 August 2021.

29 Sarbanes–Oxley Act of 2002 s101 (a); 15 US Code §7211.

30 Sarbanes–Oxley Act of 2002 s101 (c) (3); 15 US Code §7211.

31 Julie Zhu and Zhang Yan, 'Scrutiny Mounts on China's Luckin Coffee as Market Regulator Inspects' *Reuters* (27 April 2020).

32 Echo Wang, 'Nasdaq to Tighten Listing Rules, Restricting Chinese IPOs-Sources' *Nasdaq* (18 May 2020).

Inadequate oversight of audits

The reliability of financial statements is one of several challenges faced by investors. The role of IPO advisers has come under greater scrutiny, including whether the auditors involved performed adequate due diligence on Luckin Coffee.³³ A ULCC is generally audited by auditors based in China. The combined revenue from Chinese affiliations of the Big Four made up 26 per cent of the total Chinese accounting market; the Big Four audit about half of all Chinese-listed companies in the USA.³⁴ The auditor of Luckin Coffee Inc. has been Ernst & Young Hua Ming LLP, a PCAOB-registered firm since 2004 and thus eligible to serve as lead auditor on the audits of ULCCs.³⁵ Nevertheless, it has never been subject to a PCAOB inspection. It was the Chinese arm of Ernst & Young, Luckin Coffee's auditor, that confirmed the fraud. The Ernst & Young findings came only after multiple reports by short-sellers that questioned the authenticity of Luckin Coffee's sales and other key figures.³⁶ Confidence in the auditor of Luckin Coffee will be even more critical in light of apparent control failures at the Company. Luckin Coffee's fraud has brought up further questions concerning the auditing process, that is, how such a major fraud could not have been caught by auditors until so far down the line. Another key concern is whether Ernst & Young, the listing intermediary, could be held accountable with regard to the failure to detect the fraud. A critical concern is whether it is in the interest of US investors that Ernst & Young Hua Ming LLP should remain a PCAOB-registered firm, and whether PCAOB should deregister them for their role in the debacle.³⁷ This scandal represents another blow to PCAOB's confidence in the processes of audit firms that it has not been permitted to inspect for more than a decade.³⁸

3. The unviable and unsustainable *de facto* two-tier compliance system

Confidence in the quality and reliability of financial statements is driven by a combination of quality audit services and regulatory oversight.³⁹ PCAOB's inspections are used to make certain that audits of US-listed companies must comply with US auditing standards. However, the US regulators face significant challenges in overseeing the financial reporting for ULCCs. The PCAOB cannot inspect audit work and practices of PCAOB-registered accounting firms in China with respect to their audit work of US reporting companies.

33 Jacky Wong, 'Chinese Growth Becomes a Tougher Sell on Wall Street: Accounting Fraud Highlights Corporate-Governance Concerns' *The Wall Street Journal* (9 April 2020).

34 Wei Zhou and Hong Shen, 'Chinese Auditors Are on the Hook after Clients Are Caught Cooking the Books' *The Wall Street Journal* (2 August 2019).

35 Sarbanes-Oxley Act of 2002 ss106A (1) and (2).

36 Lockett (n 24).

37 Bob Pisani, 'Luckin Coffee is a Painful Reminder of "the Extreme Fraud Risk" of Some China-Based Companies' *CNBC* (3 April 2020).

38 Mahoney (n 18).

39 Clayton and others (n 2).

Such barriers undermine the fair and transparent financial reporting at the heart of the US capital markets. As a result, ULCCs are generally not subject to the same requirements as apply to domestic US issuers. Such differences impact the quality of information provided to investors.

Longstanding deadlock: the PCAOB's inability to inspect audit work papers in China

As the US government's principal audit watchdog, the PCAOB conducts regular inspections of both foreign and domestic registered public accounting firms.⁴⁰ It is empowered to bar firms that violate its rules from auditing companies that trade on US exchanges.⁴¹ Information necessary for PCAOB's regulatory oversight is not always available from foreign jurisdictions, which holds particularly true with regard to Chinese accounting firms. Neither PCAOB's direct investigations in China nor the providing of documentation to PCAOB is allowed under the Chinese law.⁴² The PCAOB's inability to inspect Chinese issuers' audit work has adversely affected investors, who cannot receive the tangible, quality-enhancing benefits they should have received from PCAOB inspections.⁴³

PCAOB: the gatekeepers' gatekeeper

PCAOB's inspections and SEC regulatory activities help to improve audit quality for the inspected Chinese auditors' US-listed clients.⁴⁴ PCAOB has built an effective system for registration, inspection, rule-making and enforcement, so as to provide essential safeguards.⁴⁵ PCAOB seeks to protect investors in the US capital markets by ensuring that audit firms adhere to PCAOB standards. It oversees the audits of public companies, and its inspection power transcends borders. The inspections are a key component of the US regulatory efforts to enhance the quality of financial reporting and ensure audit quality.⁴⁶ Non-US accounting firms must register with the PCAOB and abide by its guidelines if they intend to issue audit reports for US-listed firms.⁴⁷ In view of jurisdiction, any audit firm that registers with the PCAOB is legally obligated to provide documents regardless of

40 Sarbanes–Oxley Act of 2002 ss101C (3) and (4).

41 Sarbanes–Oxley Act of 2002 s105 (b) (3) (A) (i); 15 US Code §7215.

42 US Department of the Treasury, 'President's Working Group on Financial Markets Releases Report and Recommendations on Protecting Investors from Significant Risks from Chinese Companies' (6 August 2020) <https://home.treasury.gov/news/press-releases/sm1086> (accessed 10 August 2021).

43 Phillip Lamoreaux, 'Does PCAOB Inspection Access Improve Audit Quality? An Examination of Foreign Firms Listed in the United States' (2016) 61 *Journal of Accounting & Economics* 313, 337.

44 James R Doty, 'The Relevance, Role, and Reliability of Audits in the Global Economy' (2012) 90 *Texas Law Review* 1891, 1911.

45 Brandon Gipper, Christian Leuz and Mark Maffett, 'Public Oversight and Reporting Credibility: Evidence from the PCAOB Audit Inspection Regime' (2020) 33 *The Review of Financial Studies* 4532–4579.

46 Jay Clayton and others, 'Statement on Continued Dialogue with Audit Firm Representatives on Audit Quality in China and Other Emerging Markets' (Washington DC, SEC, 19 February 2020) <<https://www.sec.gov/news/public-statement/statement-audit-quality-china-2020-02-19>> accessed 10 August 2021.

47 PCAOB, 'Public Companies that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions where the PCAOB is Denied Access to Conduct Inspections' (Washington DC, PCAOB, 1 April 2020) <<https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx>> accessed 10 August 2021.

their locations. SEC and PCAOB jointly acknowledged that ‘for investors, both US and non-US investors, US listing carries with it the assumption that US rules and regulatory oversight apply’.⁴⁸ Thus, PCAOB has jurisdiction over companies listed on the US stock exchanges that are based in China.⁴⁹ It is worth noting that some gatekeepers, to a greater extent, play a rubber-stamp role in detecting and deterring financial fraud.⁵⁰ Rather than acting as gatekeepers, some accounting firms have turned a blind eye to their clients’ fabricated financial statements. For instance, they do not have access to those company’s actual books and records, despite their signing off on company financial statements in China.

Forbid PCAOB’s inspection on grounds of national security and state secrecy

China has routinely denied access to overseas regulators, arguing that allowing the USA to enforce US laws in China would violate its national sovereignty and risks disclosure of state secrets.⁵¹ Chinese laws have been invoked to limit foreign access to China-based audit work papers. A newly effective law has essentially codified the position:⁵² the amended China Securities Law (CSL 2020) coming into effect on 1 March 2020 requires that financial records remain in China and also bars foreigners from sharing information on grounds that it might contain state secrets.⁵³ The CSL 2020 has far-reaching consequences on auditors as well as Chinese issuers listed on the US stock exchanges. It restricts the auditors documentation of work performed in China from being transferred outside the country.⁵⁴ In addition, the China National Security Law (NSL 2015) limits US regulators’ ability to oversee the financial reporting of Chinese issuers,⁵⁵ but also shields them from complying with the US laws for financial transparency and accountability. The NSL 2015 is invoked at times to limit US regulators’ ability to oversee the financial reporting of ULCCs. These laws create obstacles to cross-border flows of information between regulators and China-domiciled registrants, thus complicating and impeding the PCAOB’s ability to carry out regulatory responsibilities.

Furthermore, positions taken by the CSRC impair the PCAOB’s ability to conduct inspections in China, even though these firms are registered with the PCAOB. CSRC does not permit the PCAOB to inspect its public accounting firms or provide sufficient access to inspect and investigate the audits of such ULCCs. The PCAOB has run into obstacles inspecting the work of the auditors hired by 224 US-listed companies, primarily from the

48 Clayton and others (n 2).

49 Shaswat Das, ‘Chinese Investment in the United States: Impacts and Issues for Policymakers’ (Washington DC, Testimony before the U.S.-China Economic and Security Review Commission, 26 January 2017) <https://www.uscc.gov/sites/default/files/Das_USCC%20Hearing%20Testimony012617.pdf>.

50 Qingxiu Bu, ‘Suspension of Chinese Units of “Big 4” Audit Firms: The Question of Moral Turpitude’ in Susan Watson and PM Vasudev (eds), *Global Capital Markets: A Survey of Legal and Regulatory Trends* (Edward Elgar Publishing 2017) 35, 61.

51 Colleen Honigsberg, ‘The Case for Individual Audit Partner Accountability’ (2019) 72 (6) *The Vanderbilt Law Review* 101, 151.

52 Cydney Posner, ‘SEC Preparing Proposals to Implement Recommendations Regarding Emerging Market Listings’ *Harvard Law School Forum on Corporate Governance* (Harvard Law School, 30 August 2020).

53 China Securities Law (hereinafter referred to as CSL 2020) art 177.

54 David Alexander, ‘US Lawmakers Push U.S.-Listed Chinese Firms to Comply with Financial Oversight’ *Reuters* (6 June 2019).

55 National Security Law of the Peoples Republic of China (NSL 2015) arts 59; 77 (7).

Chinese mainland, of which more than 130 issuers are audit clients of PCAOB-registered firms.⁵⁶ The SEC and PCAOB face challenges from Chinese laws that impede effective regulation, supervision and enforcement. Neither the SEC and PCAOB have access to accounting documents, nor can they promote and enforce disclosure standards for US-listed companies operating in China.⁵⁷ The restriction results in additional challenges to disclosure and transparency requirements for ULCCs. The inability to achieve efficient regulatory cooperation with Chinese authorities raises a number of concerns about investor protection. Information barriers that inhibit PCAOB's oversight may allow bad actors to more effectively hide fraud. Given the recent surge in the number of ULCCs, the PCAOB has sought, without success, inspections of China-based audit firms and the mainland affiliates of the Big Four accountancy firms.⁵⁸ Unsuccessful resolution of these obstacles entails the continuing inability of PCAOB to inspect PCAOB-registered firms.⁵⁹ As such, a *de facto* two-tier compliance system has come into being.

A *de facto* double-standard compliance system

The flow of international capital investment presents substantial challenges for the US regulators to ensure a level playing field in transparency and accountability in financial reporting globally. Legal obligations have been established to render foreign issuer governance equivalent to domestic issuers to protect investors. US securities laws that apply to the ULCCs should be the same as those that apply to US public companies. Given that US enforcement is severely limited, investors are left potentially exposed to significant risks.

Unequitable disclosure regimes due to the *de facto* double standard

Accurate and reliable audited financial statements are critical to investors in making informed decisions and are vital to the overall well-being of the US capital market.⁶⁰ Chinese firms are allowed to be cross-listed on US stock exchanges even though they are shielded from PCAOB's inspections but they should subject themselves to the stricter US legal environment and enhanced disclosure requirements for the sake of the investor protection.⁶¹ The current *de facto* two-tiered system renders it a paramount challenge to ensure that all companies on the US stock exchanges are subject to the same standards and regulations. A number of ULCCs do not meet the same disclosure and auditing standards, despite that they are subject to the same requirements as their domestic US counterparts. The Chinese firms receive, in effect, preferential treatment over the latter. There is a risk of increased financial fraud arising from the resultant *de facto* gap in disclosure and auditing

56 Doty (n 44).

57 Clayton and others (n 28).

58 Matthew Miller, 'US, HK Regulators Struggle to Get China Audit Papers' *Reuters* (20 December 2017).

59 PCAOB, 'Consideration of Registration Applications from Public Accounting Firms in Non-US Jurisdictions Where There Are Unresolved Obstacles to PCAOB Inspections' (Washington DC, PCAOB Rel. No 2010-007, 7 October 2010) <https://pcaobus.org/International/Inspections/Documents/Registration_of_Non-US_Firms.pdf> accessed 10 August 2021.

60 David Sherman and David Young, 'Where Financial Reporting Still Falls Short' (2016) 6 *Harvard Business Review* 76, 84.

61 Andrew Karolyi, 'The World of Cross-Listings and Cross-Listings of the World: Challenging Conventional Wisdom' (2006) 10 (1) *Review of Finance* 99, 152.

standards, which ultimately is unviable and unacceptable. This risk is likely to remain a long-standing challenge given that the potential rewards are so high, while the risks from getting caught are minimal. In consequence, the ULCCs do not have the same incentives to provide a true picture of their financial health to investors as domestic US issuers.⁶² Significant American capital is exposed to the risk created by China's lack of economic transparency.⁶³ US regulators can neither inspect such companies for compliance with US laws nor take enforcement action when laws are violated. With the asymmetric issue undressed, the risk will be borne by investors, making them a ripe target for companies that exhibit far less transparency relative to other global peers forced to meet high disclosure requirements.⁶⁴

Level the playing field via legislative reforms

Accountability for issuers and gatekeepers is a key aspect of US securities law. Companies in China generally are not subject to the same standards as applied within the USA.⁶⁵ The differences inevitably impact the quality of information provided to investors. Both Chinese and US domestic publicly listed firms should be committed to compliance following the same standard. The issue of extraterritoriality makes it nearly impossible for PCAOB to conduct the same level of due diligence for ULCCs, which poses insurmountable challenges to the US enforcement efforts. This puts the SEC and PCAOB in a precarious position to ensure compliance with audit requirements, and protect US investors who are interested in these securities.⁶⁶ Given the significant information barriers that persist, remedial actions involving US-listed Chinese companies are of considerable significance. The long-standing deadlock catalyses a systematic and hard-line strategy on the Chinese firms. Changes need to be made to level the playing field for domestic US companies competing for the same capital. As such, the USA has been seeking to enact new laws to allow for tighter listing standards for companies based in a jurisdiction where its laws and regulations restrict PCAOB's access to information. On a statutory footing, the SEC will be authorized to delist a company if PCAOB cannot access its audit.

4. Would HFCAA be a panacea?

Trump's trade war with China has set in motion some efforts to decouple the world's two biggest economies,⁶⁷ which is also manifested in the capital markets. As the frontline guardians of accurate financial statements, the PCAOB considers examining whether

62 Honigsberg (n 51).

63 Rubio (n 11).

64 Joe Liebkind, 'Loophole Exploitation Aggravates Chinese and Foreign Regulators' *International Policy Digest* (26 September 2019).

65 SEC, 'Disclosure Considerations for China-Based Issuers' (Washington DC, SEC, 23 November 2020) <<https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers>> accessed 10 August 2021.

66 Jane Fuller, 'Time for the Big Four to Rethink Auditing's Purpose' *Financial Times* (7 January 2020).

67 Edward Wong, 'Chinese Coffee Chain's Scandal Renews U.S. Calls for Oversight' *The New York Times* (New York, U.S., 30 April 2020).

some of the PCAOB-registered firms located in China should be deregistered.⁶⁸ As discussed above, Information asymmetry, Chinese IPOs lack of accounting transparency and close ties to powerful insiders leave investors facing a higher risk of fraud.⁶⁹ One of the legislative intentions behind HFCAA is to force ULCCs to play by the same transparency rules as those from other parts of the world, meanwhile allowing the PCAOB to inspect audits of them.⁷⁰ Another major concern about HFCAA is that it may have an adverse effect on US capital markets. Some ULCCs are already dually listed or preparing for dual listings to reduce the impact of any potential US action.⁷¹

Mandatory inspection and enhanced disclosure commitment

In practice, a failure to provide the SEC with full audit reports will generate its own penalties through lower share prices as investors mark these stocks down.⁷² Due largely to an increasingly complicated structure in which Chinese firms manage to get listed in the USA, the existing regulatory framework is inadequate to address the risk of fraud. *Luckin Coffee* is a wake-up call for US policy makers, regulators and investors about the risk of extreme fraud that Chinese companies pose to the US capital market. It is essential to adopt a drastic step of compulsory delisting that would strengthen the precaution system while safeguarding the integrity of the US capital market. HFCAA aims to mandate the delisting of foreign companies that fail to comply with auditing regulations. A clear message is that all ULCCs must be committed to financial transparency and accountability under the US securities law, which is a prerequisite to be listed on US exchanges.

A real game changer?

The purpose of HFCAA is to ensure that audits of ULCCs can be inspected by the PCAOB, and thus enhance transparency. The legislative intent behind the HFCAA is to better inform investors about their exposure to financial risks, delist non-compliant issuers and ban those firms that flaunt investor protections from entering US capital markets.⁷³ HFCAA would force US-listed Chinese firms to submit to more regulatory oversight or face delisting. HFCAA requires Chinese companies to establish that they are not owned or controlled by a foreign government and submit to an audit that the PCAOB can review.⁷⁴ It is aimed to address long-standing unfair practices arising from China's substantial subsidies for its state-owned enterprises (SOEs), which constitutes unfair

68 Mahoney (n 18).

69 Wang (n 32).

70 Jesse Fried, 'Why Trump's Attempt to Delist China from US will Backfire' *Financial Times* (13 January 2021).

71 Joanne Chiu, 'Two Chinese Tech Firms Prepare Hong Kong Listings as US Pressure Rises' *The Wall Street Journal* (27 May 2020).

72 Kevin Rudd, 'Has the "Great Decoupling Gone Viral?' *Project Syndicate* (7 February 2020).

73 U.S. Senators Marco Rubio (R-FL) and Bob Casey (D-PA), 'Rubio, Colleagues Introduce Bipartisan, Bicameral Bill to Ban Chinese & Foreign Firms that Flaunt US Laws from U.S. Exchanges' (Washington DC, 5 June 2019). <<https://www.rubio.senate.gov/public/index.cfm/2019/6/rubio-colleagues-introduce-bipartisan-bicameral-bill-to-ban-chinese-foreign-firms-that-flaunt-u-s-laws-from-u-s-exchanges>> accessed 10 August 2021.

74 HFCAA s2.

competition with their foreign counterparts.⁷⁵ In addition, HFCAA requires ULCCs to comply with US auditing and reporting requirements. Amending the Sarbanes–Oxley Act (SOX 2002),⁷⁶ the law requires each ‘covered issuer’ to disclose annually to the SEC the:

- (1) provisions of laws or rules in foreign jurisdictions that prevent the PCAOB from performing its inspections of auditors located in such foreign jurisdictions; and
- (2) date when such provisions no longer prevent said PCAOB inspections.⁷⁷

The law authorizes the SEC to prohibit trading in a company if the PCAOB is unable to review company audits.⁷⁸ If the PCAOB is prevented from carrying out an inspection of the auditor for three consecutive years, the SEC is authorized to prohibit the covered issuer’s securities from being traded on a national securities exchange,⁷⁹ unless such covered issuer certifies to the SEC that it will retain a registered public accounting firm that the PCAOB is able to inspect.⁸⁰ The Chinese situation falls squarely under Section 2(A) of HFCAA, where a ULCC:

employs an auditing firm located in a foreign jurisdiction, and to which the PCAOB lacks the ability to inspect the audits conducted by those firms under section 3(A) of the Act.⁸¹

If any of these Chinese Companies is a foreign issuer⁸² and has a registered public accounting firm described in Section 2 of this Act and prepares an audit report during a non-inspection year, it must make additional disclosure.⁸³ During a non-inspection year, the foreign non-inspected issuer must disclose, among other things, the percentage of its shares owned by government entities in its home jurisdiction and whether government entities in the foreign jurisdiction have a controlling financial interest in such a foreign reporting issuer.⁸⁴ The demand for a full disclosure of state ownership further complicates the issue politically.

In terms of financial transparency and accountability, HFCAA sends a clear message to the Chinese policymakers and regulators. If China continues to refuse to allow PCAOB to conduct inspections, then its companies will not have access to the US market. Making common-sense changes to level the playing field, HFCAA seeks and provides investors the

75 Chad P Bown and Jennifer A Hillman, ‘WTO’ing a Resolution to the China Subsidy Problem’ (Washington DC, PIIE, October 2019) <<https://www.piie.com/sites/default/files/documents/wp19-17.pdf>> accessed 10 August 2021.

76 Sarbanes–Oxley Act of 2002 (15 USC §7214).

77 A ‘covered issuer’ is a reporting company with a registered public accounting firm that (i) is located in a foreign jurisdiction and (ii) the PCAOB is unable to inspect because of the applicability of laws or rules of such foreign jurisdiction.

78 HFCAA s2(i)(3).

79 Covered issuers are defined as those required to file periodic reports under ss 13 or 15(d) of the Securities Exchange Act of 1934.

80 HFCAA (n 74).

81 HFCAA ss2 (a), 3(a).

82 17 CFR § 240.3b–4(b): the term ‘foreign issuer’ means any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country.

83 HFCAA s3(b)(2): ‘the percentage of the shares of the issuer owned by governmental entities in the foreign jurisdiction in which the issuer is incorporated or otherwise organized’.

84 HFCAA ss3(b)(2) and (3).

transparency they need to make well-informed decisions.⁸⁵ It could potentially change the current equation. However, it remains ambiguous what consequence the Chinese firms that fall under Section 2(A) of HFCAA face if they fail to certify that they are not owned or controlled by the Chinese government. It is unclear whether they would be permitted to continue being listed or forced to delist from the US exchanges. It remains to be seen whether the disclosure of ULCCs' ownership structure would achieve HFCAA's legislative intent. It is similarly unclear what constitutes 'owned or controlled by a foreign government' for purposes of HFCAA. The term 'foreign private issuer' does not exclude a company that is 'owned or controlled' by a foreign government.⁸⁶ It seems intended that such an issuer should not be owned or controlled by a government entity in a foreign jurisdiction.⁸⁷

Dilemma: between a rock and hard place

A regulatory gap arises when foreign issuers move from a weak governance regime to a stronger one as result of a cross-border listing.⁸⁸ HFCAA seeks to bridge the visible gap by equipping the SEC with powerful enforcement mechanisms through which the agency could delist a foreign entity skirting PCAOB's audit inspections. Chinese issuers are subject to jurisdiction-based regulatory requirements. HFCAA could create a compliance dilemma for ULCCs, which are actually caught in a proverbial situation, ie between a rock and hard place. A deadlock hence arises in terms of a failure either to conform to the US disclosure rules or comply with the Chinese law. The compliance dilemma is fundamentally rooted in the tension between the laws of China, and the US HFCAA presents a dilemma for the ULCCs insofar as they will be required to comply with directly conflicting laws. If Chinese firms intend to be listed on the US stock exchanges, by implication they are committed to complying with US laws and regulations on financial transparency and accountability. It is the Chinese law that prevents them from complying with disclosure rules and SEC audit. Chinese issuers often argue that they are normally caught between a rock and hard place, having to decide whether to break the Chinese or the US law.⁸⁹

From a perspective of auditors, the PCAOB could deregister accounting firms that it is unable to inspect. The termination would lead to the delisting of shares of companies, since financial statements audited by a PCAOB registered accounting firm are a prerequisite condition for continued listing. The suspension of the Big Four epitomizes the

85 Daniel Flatley and Ben Bain, 'Senate Overwhelmingly Approves Bill to Delist Certain Chinese Companies' *Fortune* (Fortune Media Group Holdings, 20 May 2020).

86 Amended SOX 2002 s104(i)(2)(B).

87 HFCAA s2(2)(B).

88 Amir Licht, 'Cross-Listing and Corporate Governance: Bonding or Avoiding?' (2003) 4 (1) *Chicago Journal of International Law* 141, 163.

89 USCC, 'Chinese Investment in the United States: Impacts and Issues for Policymakers—Hearing before the United States-China Economic and Security Review Commission' (Washington DC, USCC, 26 January 2017) <<https://www.uscc.gov/sites/default/files/transcripts/Chinese%20Investment%20in%20the%20United%20States%20Transcript.pdf>> accessed 10 August 2021.

PCAOB's enforcement action, because their subsidiaries based in China have failed to co-operate in PCAOB investigations of their audit work.⁹⁰ A plausible challenge would be how to apply HFCAA if most ULCCs would be unable to file audited financial statements with the SEC.

The potential collateral consequences on ULCCs

HFCAA threatens to delist from US exchanges any firm which fails to provide regular audited reports to the PCAOB. Failure to satisfy this listing standard would put the company at risk of delisting. This would considerably affect ULCCs in that many of them have failed to comply. The rising USA–China tensions could negatively influence investor sentiment towards Chinese stocks, and the implementation of HFCAA could have a negative impact on ULCCs, which would likely respond by seeking dual listing. One option would be a secondary listing elsewhere and giving investors new shares in exchange for the US stocks, which could help them alleviate both regulatory and investor concerns. Given the dilemma between a rock and hard place, HFCAA would likely affect Chinese firms' willingness to list in the USA. This would also provide an opportunity to attract Chinese companies for the US's rival stock exchanges, such as Hong Kong, London and China's newly launched STAR market for start-ups.

Alternatives remain uncertain: LSE *vis-à-vis* HKSE

It is imperative for ULCCs to continue accessing global capital markets to balance the current account.⁹¹ They may explore alternative listing venues prior to proceeding with the delisting process in the USA. One option would be a secondary listing elsewhere and giving investors new shares in exchange for the US stocks.⁹² The result of a mass delisting would likely be a surge of IPOs on the Hong Kong exchange.⁹³ The 'differential voting rights (DVRs)' prevented many Chinese firms from previously accessing the Hong Kong Stock Exchange (HKSE) and London Stock Exchange (LSE). The DVR refers to the issuance of multiple classes of shares, each of which entitles the holders to different voting rights. In certain circumstances, this results in investors holding majority economic ownership of a company, but not necessarily commanding the majority voting rights.⁹⁴ This innovative design of voting rights makes it more attractive for Chinese firms incorporated in offshore havens, which helps owners maintain a tiered voting structure.⁹⁵ HKSE has

90 Michael Rapoport, 'SEC, Big Four Accounting Firms in China Settle Dispute' *The Wall Street Journal* (6 February 2015).

91 Chutian Zhou, 'Why Are Chinese Stocks Dropping in the US?' *The Diplomat* (Washington DC, U.S., 26 May 2020).

92 John Ruwitch and Alun John, 'What Delisting Chinese Firms from U.S. Stock Markets Could Mean' *Reuters* (London UK, 30 September 2019).

93 David Gomulya and others, 'Crossed Wires: Endorsement Signals and the Effects of IPO Firm De-Listings on Venture Capitalists Reputations' (2019) 62 (3) *Academy of Management Journal* 641, 666.

94 Coffee (n 3).

95 David C Donald, 'Market Quality' and Moral Hazard in Financial Market Design' in Ross P Buckley, Emilius Avgouleas and Douglas W Arner (eds), *Reconceptualising Global Finance and its Regulation* (Cambridge University Press 2016) 217–35.

since changed its stance towards dual-class shares which assign different voting rights (like DVRs), paving the way for a secondary offering of Alibaba shares in its exchanges.⁹⁶

In 2018, HKSE changed its rules to allow companies with dual-class shares to list, which also instituted landmark revisions to the Hang Seng Index.⁹⁷ The HKSE Listing Rules offers a new concessionary route which allows firms that are already primarily listed on a Qualifying Exchange, including the NYSE, NASDAQ and the Main Market of the LSE, to apply for a secondary listing in Hong Kong.⁹⁸ The listing reforms will pave the way for ULCCs to list in the HKSE. Alibaba's secondary listing in Hong Kong in November 2019 has netted the company nearly US\$13 billion in additional capital.⁹⁹ Alibabas success has mainstreamed a growing trend of secondary listings by massive Chinese companies in the technology sector. JD.com Inc. and NetEase Inc. were secondarily listed in HKSE in April and June 2020, which raised US\$4 billion and US\$2.8 billion respectively.¹⁰⁰ Hong Kong seemingly emerges as a leading fundraising hub for Chinese tech companies. Nevertheless, erosion of the rule of law in Hong Kong could lessen future foreign capital inflows, ultimately impacting Hong Kong's status as an international financial centre.¹⁰¹ This is especially true in terms of the delisting and relisting strategy exploited by many Cayman-incorporated companies.¹⁰²

The LSE is viewed as another main alternative.¹⁰³ The London-Shanghai Stock Connect (LSSC), a scheme between LSE and Shanghai Stock Exchange (SSE), was launched in 2019. The LSSC was designed to allow eligible companies listed in each market to issue on the other exchange a depositary receipt that can be traded under local rules in the local time zone.¹⁰⁴ Shanghai-listed A-share companies wishing to be traded in the LSE may do so through the issuance of Global Depositary Receipts while London-listed companies may list on the SSE directly by issuing Chinese Depositary Receipts.¹⁰⁵ From China's perspective, there is no ready alternative to the diversity, depth and liquidity of US capital markets.¹⁰⁶ Despite a suspension of the LSSC in early 2020 due to HK frictions, China may use it as a hedge against moves by the USA to make it harder for Chinese companies to be listed on the NYSE and NASDAQ.¹⁰⁷ The LSSC could open up an opportunity for

96 Vijay Govindarajan and others, 'Should Dual-Class Shares Be Banned?' *Harvard Business Review* (Harvard Business Publishing, 3 December 2018).

97 Noah Sin and others, 'Hong Kongs Hang Seng benchmark paves way to include Alibaba' *Reuters* (London UK, 18 May 2020).

98 HKSE Listing Rules ch 19C.

99 Stu Woo, 'Alibaba Shares Enjoy a Strong Start in Hong Kong' *The Wall Street Journal* (Almar Latour, 26 November 2019).

100 Chiu (n 71).

101 Bobby V Reddy, 'Finding the British Google: Relaxing the Prohibition of Dual-Class Stock from the Premium-Tier of the London Stock Exchange' (2020) 79 (2) *Cambridge Law Journal* 315, 348.

102 Liebkind (n 64).

103 Kenneth Rapoza, 'China Tries Getting out Ahead of NYSE, Nasdaq "Delisting"' *Forbes* (Forbes, Inc., 19 May 2020).

104 Mike Bird, 'The Shanghai-London Stock Link Is a Financial White Elephant' *The Wall Street Journal* (3 January 2020).

105 Lerong Lu and Ningyao Ye, 'Shanghai-London Stock Connect: Operating Mechanism, Opportunities, and Challenges' (2019) 34 (10) *Butterworths Journal of International Banking and Financial Law* 684, 687.

106 Kevin Rudd, *Defining the Great Global Decoupling* (Asian Society Policy Institute 4 November 2019) <<https://asiasociety.org/policy-institute/events/defining-great-global-decoupling>> accessed 10 August 2021.

107 Yu Sun, Yuan Yang and Philip Stafford, 'China Halts London Listing Tie-up after HK Fictions' *Financial Times* (London UK, 3 January 2020).

Chinese companies to raise foreign capital in London. Such migration could be promising for companies seeking a fresh injection of capital in a new market.¹⁰⁸ In addition, the LSE's junior market (AIM) has a fast track route to listing for issuers already listed on designated markets including the top tier markets of NASDAQ and NYSE.¹⁰⁹ With the publication of Lord Hills Review on the UK Listing Regime on 3 March 2021,¹¹⁰ it is anticipated that proposed changes to the UK listing rules will make it more attractive for fast-growing technology and other companies to list in London, and thus LSE's competitiveness will be enhanced. It remains to be seen which one could be a game changer between the LSE and HKSE.

China's Star Market: a worthy rival of the NASDAQ?

Shenzhen and Shanghai could be beneficiaries with Hong Kong in turmoil.¹¹¹ Hong Kong's rule of law along with its open capital environment have long been its advantages over Shenzhen Stock Exchange and SSE. The recent issue of the National Security Law casts a cloud over the financial centre's future.¹¹² For instance, the Hang Seng Index fell nearly 6 per cent right after the passing of the law on 30 June 2020.¹¹³ China has established decade-old NASDAQ-like listing venues to attract tech start-ups in Beijing, Shenzhen and Shanghai.¹¹⁴ In June 2019, the SSE launched the NASDAQ-like Star Market which allows pre-profit companies in areas such as AI and cloud computing to list in China for the first time. The pressure to abide by more stringent disclosure requirements in the USA could be one reason why some Chinese companies are looking elsewhere. Since the Star Market is less accessible to foreign investors to attract more listings, it remains uncertain as to whether the SSE Star Market could become a worthy rival of the NASDAQ.

Race to the bottom vis-à-vis race to the top

There is increasingly fierce competition to attract listings across jurisdictions. In the case of a dual-listing, the issuer will need to coordinate disclosure of inside information across

108 Nicholas M Hanna and Mark Tan, 'London's New Appeal for Chinese Companies Looking to List' *National Law Review* (29 May 2020).

109 London Stock Exchange, 'AIM' <<https://www.londonstockexchange.com/raise-finance/equity/aim>> accessed 10 August 2021.

110 UK HM Treasury, 'Terms of Reference: Lord Hill's Review on Listings' *UK HM Treasury* (London, 5 March 2021) <<https://www.gov.uk/government/publications/uk-listings-review/terms-of-reference-lord-hills-review-on-listings>> accessed 10 August 2021.

111 Jacky Wong, 'Chinese Companies Fleeing New York Will Find Warm Welcome at Home' *The Wall Street Journal* (25 May 2020).

112 China's National People's Congress Standing Committee (NPCSC) passed a national security law (NSL) for the Hong Kong Special Administrative Region (HKSAR) on 30 June 2020. 'Can Hong Kong Remain a Global Financial Centre?' *Economist* (6 June 2020).

113 Sherisse Pham, 'Hang Seng Index Has Worst Day Since 2015 as Tensions Flare up again between China and the West' *CNN Business* (22 May 2020).

114 Shen Hong, 'First IPO on China's Nasdaq-Style Tech Board Sparks a Small Frenzy' *The Wall Street Journal* (26 June 2019).

the two markets. Exchanges have plausibly fewer incentives to impose strict listing and governance rules, lest they lose a listing to a foreign competitor.¹¹⁵ The Star Market's listing requirements are less stringent as compared to the NASDAQ. The potential listing of Saudi Aramco shares has at once prompted the LSE to propose a relaxation of its listing standards for sovereign issuers on the premium listing tier.¹¹⁶ It has been argued that offering valuable SOEs, like Saudi Aramco, preferential treatment, the Financial Conduct Authority would put investors at serious risk.¹¹⁷ HFCAA and NASDAQ's tightening of its listing requirements prove positive for the integrity of the US markets, as Luckin Coffee is not the first ULCC to have imploded due to a governance scandal.¹¹⁸ On the one hand, a 'race to the top' approach in US governance could potentially lead some weak ULCCs to seek a dual listing elsewhere. Due to the bonding theory, on the other hand, the approach would lead some Chinese companies with strong governance regimes considering listing in the USA to instead list in Hong Kong, China or London.

Seeking leverage: a double-edge sword or a sword of Damocles

The US capital markets depend on rigorously enforced disclosure and corporate governance regulations that help to prevent fraud.¹¹⁹ The SEC can delist companies that are not audited by PCAOB-registered firms, which has been rarely enforced because of the potential economic and political ramifications.¹²⁰ If these companies were delisted because their auditors were deregistered, effectively losing their licences to audit US-listed firms, then the impact on the USA and China would be huge.

Delisting in the decoupling era?

Threatening to cut off access to US capital markets for Chinese companies is yet another way for the USA to escalate its trade war with China.¹²¹ Chinese firms would no longer be able to list in the USA should the decoupling contagion begin to infect capital markets.¹²² Many Chinese firms appear to be stung by the stereotyping effect following revelations of Luckin's fraud,¹²³ which highlights the tremendous risk posed by such investments. The Luckin scandal has cast suspicions on the due diligence process at accounting firms, and

115 Alissa Kole Amico, 'The Problem with Foreign Issuers' (Harvard Law School Forum on Corporate Governance, 23 June 2020) <<https://corpgov.law.harvard.edu/2020/06/23/the-problem-with-foreign-issuers/#more-130490>> accessed 10 August 2021.

116 Garen Markarian and Tobias Stockhausen, 'Quo Vadis: Politics, Uncertainty and Saudi Aramco' (2018) 11 (6) *The Journal of World Energy Law & Business* 487, 505.

117 Alissa Kole Amico, 'A Regulatory Race to the Bottom?' *Project Syndicate* (14 August 2017).

118 Amico (n 115).

119 President's Working Group on Financial Markets, *Protecting United States Investors from Significant Risks* (The Department of the Treasury 24 July 2020) <<https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf>> accessed 10 August 2021.

120 Benjamin Bain and Jenny Leonard, 'Trump's China Financial Decoupling Move Has Roots in Enron Saga' *Bloomberg Quint* (12 October 2019).

121 James Politi and Christian Shepherd, 'US and China Strike "Phase One" Deal to De-Escalate Trade War' *Financial Times* (13 December 2019).

122 Kevin Rudd, *To Decouple or Not to Decouple?* (Asian Society Policy Institute 4 November 2019) <<https://asiasociety.org/policy-institute/decouple-or-not-decouple>> accessed 10 August 2021.

123 Lockett (n 24).

provided new ammunition to PCAOB pursuing cross-border enforcement.¹²⁴ In this vein, allowing inspections would not seem to be a huge concession for China to make in a settlement of the trade war. After all, any audit firm that registers with the PCAOB is legally obligated to cooperate and provide documents regardless of their locations.¹²⁵ A refusal to cooperate, either in an inspection or an investigation, could subject the firm to SEC or PCAOB sanctions and remedial measures. Positively, the threatened delisting could lead to ULCCs' more credible disclosures and further enhance investors' confidence. The last thing could be that ULCCs would be likely to move somewhere else, if HFCAA were not used properly as leverage to help PCAOB obtain inspection rights.

Implications on the US capital market

Delisting has been called a nuclear option, since it would effectively revoke the listing of Chinese companies in the USA, with a potentially adverse impact on the Big Four, investors and the US stock exchanges.¹²⁶ Goldman Sachs estimated that US investors currently hold US\$350 billion worth of Chinese American Depositary Receipts (ADRs), representing roughly one-third of the ADR universe.¹²⁷ More than 170 Chinese companies listed on the NASDAQ and NYSE are facing increasing scrutiny.¹²⁸ There are about 150 US-listed firms that are headquartered or operate principally in China, which market capitalization is enormous in excess of \$US2 trillion.¹²⁹ With the potential for Chinese issuers to move to other stock exchanges, the delisting could hurt the global competitiveness of US stock exchanges. The ULCCs' departure would result in a huge blow for Wall Street as the centre of global finance, let alone a substantial loss to investors. The massive delisting would undermine the ADR market, and the USA's clout as a conduit for international capital could be diminished.¹³⁰ There would be a considerable tension between the SEC and the Wall Street. The PCAOB has so far been unwilling to take unilateral action by deregistering Chinese auditors it cannot inspect, likely due to opposition from capital market participants. This creates opportunities for China to play one party off the other.¹³¹ The sheer magnitude of mutual self-interests appears to be militating against any significant decoupling.¹³² The prospects of delisting seem remote, because the large-scale

124 Jesse Fried, 'Delisting Chinese Companies Plays Straight into Their Hands' *Financial Times* (1 June 2021).

125 HFCAA s2(i) (2) (B).

126 Dave Michaels, 'Chinese Companies Could Be Forced to Give Up U.S. Listings Under Senate Bill' *The Wall Street Journal* (20 May 2020).

127 Narayanan Somasundaram, 'China-US Clash over Stock Market Rules Casts Doubt over \$1tn of Listings' *Nikkei Asian Review* (2 June 2020).

128 NASDAQ Rule 5005(a) (37): 'a "Restrictive Market" would be defined as "a jurisdiction that Nasdaq determines to have secrecy laws, blocking statutes, national security laws or other laws or regulations restricting access to information by regulators of US-listed companies in such jurisdiction."'.

129 USCC, 'Chinese Companies Listed on Major U.S. Stock Exchanges' (Washington DC, USCC, 25 February 2019) <<https://www.uscc.gov/sites/default/files/Chinese%20Companies%20on%20U.S.%20Stock%20Exchanges.pdf>> accessed 10 August 2021.

130 Ruwitch (n 92).

131 Michaels (n 126).

132 Rudd (n 106).

mutual interests are at stake in keeping capital markets open.¹³³ It remains unclear how far the USA is willing to go in addressing the conflict.

5. Address the challenge: break the deadlock

A multipronged strategy is required to address the cross-border challenge. Effective audits and regulatory oversight require timely multijurisdictional access to comprehensive information. Adequate disclosure and deterring rogue issuers constitute the bedrock of sound governance of capital markets. The Chinese market relies more on regulatory approval, while the US market relies primarily on law enforcement and civil liability.¹³⁴ A series of checks and controls should be in place to work together to ensure high-quality, reliable financial information.

Enhance deterrence from both Chinese and the US perspectives

There is extensive evidence on how the quality of accounting information affects a company's cost of capital.¹³⁵ All ULCCs must be committed to financial transparency and accountability under the US securities law, which is a prerequisite to being listed on US exchanges.

The bonding theory accounts perfectly for how ULCCs can improve the protection of investors in the USA. The operation of the ULCCs not only interprets the theory, but also reflects how the resulting improved governance benefits global capital markets. The extent to which the Chinese law contributes to the levelling of the playing field remains unclear.

Would Chinese law have teeth with extraterritorial effect?

The mile-stone CSL (2020) has extraterritorial effect, under which an article bans overseas-listed Chinese companies from harming the interests of domestic investors.¹³⁶ Regardless of a listing location, the firm should strictly abide by laws and regulations in relevant markets, and fulfil obligations to make accurate disclosures. CSL 2020 empowers Chinas securities agencies to regulate domestic companies overseas activities if they harm the interests of domestic investors.¹³⁷ The law provides a legal basis for the CSRC to investigate Luckin Coffee's misconduct allegations. However, it is arguable whether the Luckin Coffee scandal could trigger the long-arm jurisdiction given its rare application in the

133 Rudd (n 122).

134 Katharina Pistor and Chenggang Xu, 'Governing Stock Markets in Transition Economies: Lessons from China' (2005) 7 (1) American Review of Law and Economics 184, 210.

135 Richard A Lambert, Christian Leuz and Robert E Verrecchia, 'Accounting Information, Disclosure, and the Cost of Capital' (2007) 45 Journal of Accounting Research 385, 420.

136 The Standing Committee of the 13th National Peoples Congress (NPC) approved the revision of the Securities Law of the Peoples Republic of China (hereinafter referred to as CSL 2020) on 28 December 2019, which came into effect on 1 March 2020; China Securities Law 2020 art 2 (4).

137 China Securities Law 2020 art 2.

governance of the Chinese capital market. Apart from the civil compensation Luckin Coffee will likely be forced to pay,¹³⁸ SAMR has fined Luckin Coffee ¥RMB 61 million (\$8.98 million) for acts linked to its falsification of financial records and misleading of the public.¹³⁹ While China has recently changed regulations to punish instances of financial fraud onshore, the penalties remain negligible.¹⁴⁰ Previously, the cost of breaking the law was too low in China. The maximum fine for false financial disclosures is ¥RMB 600,000 (US\$87,000),¹⁴¹ while the top criminal punishment for hiding or destroying accounting records is a prison term of five years and a fine of up to ¥RMB200,000 (US\$28,000).¹⁴² In order to enhance deterrence, it is imperative to increase prison terms and fines for capital-markets misdeeds, and revoke the licences of intermediaries, including accounting firms, that failed to fulfil their duties.¹⁴³ Although the fine is increased up to ¥RMB 10 million for fraudulent disclosure,¹⁴⁴ it remains unclear whether the increased peculiar penalty could effectively deter financial fraud. Institutionally, the CSRC, the Ministry of Finance and the Chinese Institute of Certified Public Accountants continue to handle audit supervision in China. This decentralized regulatory system might be responsible for the worrying quality of auditing.¹⁴⁵ To truly improve the quality of Chinese audits, it might be useful to examine the PCAOB's experience to see how to integrate the current decentralized functions of Chinese regulators and advance reform of China's audit supervision system.¹⁴⁶

The US commitment to enhance deterrence

Investors expect that ULCCs have been subject to a consistent level of due diligence, not only upon initial listing, but also on a continuing basis.¹⁴⁷ In practice, when the PCAOB discloses its inability to inspect the audits of some ULCCs, these companies' stock prices react negatively.¹⁴⁸ Investors would consider whether significant portions of the audit may have been performed by firms in China, and the potential impact of the PCAOB's inability to access such audit work papers.¹⁴⁹ American investors who are not fully informed about

138 China Securities Law 2020 art 85.

139 Jing Yang, 'China Fines Luckin Coffee and Dozens of Firms That Helped It Inflate Results' *The Wall Street Journal* (22 September 2020).

140 Yu (n 27).

141 China Securities Law 2005 art 193.

142 Chinese Criminal Law art 161.

143 China Securities Law 2020 art 213.

144 China Securities Law 2020 art 197.

145 Huanle Deng, 'China Must Reform How It Supervises Auditors' *Caixin Global* (10 January 2019).

146 Bin Ke, Clive S Lennox and Qingquan Xin, 'The Effect of Chinas Weak Institutional Environment on the Quality of Big 4 Audits' (2015) 90 (4) *The Accounting Review* 1591, 1619.

147 Elad Roisman, 'Opening Remarks by Commissioner Roisman at the Emerging Markets Roundtable' (Washington DC, SEC, 10 July 2010) <<https://corpgov.law.harvard.edu/2020/07/10/opening-remarks-by-commissioner-roisman-at-the-emerging-markets-roundtable/#more-131305>> accessed 10 August 2021.

148 Clayton and others (n 2).

149 Clayton and others (n 28).

the fundamentally weak nature of corporate governance of Chinese firms would be subject to adverse risks.¹⁵⁰ It is imperative that PCAOB and SEC raise investors' awareness of the risks.¹⁵¹ Otherwise, investors could be subject to substantial loss when making an investment decision based on false and misleading financial data. Arguably, ULCCs are obliged to highlight the potential impacts of the PCAOB's lack of access. They should disclose that shareholders may have limited rights and remedies.¹⁵² Chinese laws may limit the legal actions they can take against companies. The US enforcement agencies have substantial difficulties in bringing and enforcing actions against ULCCs. The failure to make such disclosure might trigger SEC regulatory action.

Stock Exchanges are committed to ensuring that listing standards recognize the unique risks posed by ULCCs. NASDAQ seeks to codify its authority to apply more stringent listing criteria due to concerns about a company's auditor and apply additional initial and continued listing criteria to Restrictive Market (ie China) companies.¹⁵³ Given Chinese laws limiting access to information, NASDAQ has tightened requirements for companies seeking to go public on its exchange.¹⁵⁴ The new rules require those companies from the Restrictive Market to raise \$25 million in their IPO or, alternatively, at least a quarter of their post-listing market capitalization.¹⁵⁵ It is the first time that NASDAQ has required a minimum offering size or public float by putting a minimum value on the size of IPOs. NASDAQ would also apply additional listing criteria provided that an auditor could not be inspected by PCAOB.¹⁵⁶

Apart from the above approaches, further multipronged approaches are indispensable to address the cross-border challenge. Holding individuals accountable is a central pillar of the US enforcement strategies.¹⁵⁷ For instance, Luckin's top executives have been under civil and criminal investigations in both China and the USA.¹⁵⁸ Chief executive officers (CEOs) and chief financial officers (CFOs) of public companies should be required to certify the accuracy of their financial statements. In the longer run, it always takes time for a firm to nurture an ethical culture.

150 Broadman (n 5).

151 Jay Clayton, 'Statement Announcing SEC Staff Roundtable on Emerging Markets' (Washington DC, SEC and DoJ, 4 May 2020) <<https://www.sec.gov/news/public-statement/statement-clayton-roundtable-emerging-markets>> accessed 10 August 2021.

152 Guo (n 7) 606.

153 Restrictive Markets is defined as a jurisdiction that has laws that restrict access to information by regulators of US-listed companies in that jurisdiction, including secrecy laws, blocking statutes, national security laws or other similar laws or regulations.

154 Richard Henderson and Hudson Lockett, 'Nasdaq to Tighten Requirements for Companies Seeking to List' *Financial Times* (19 May 2020).

155 Echo Wang, 'Nasdaq to Tighten Listing Rules, Restricting Chinese IPOs' *Reuters* (19 May 2020).

156 SEC, 'Notice of Filing of Proposed Rule Change to Adopt Additional Initial Listing Criteria for Companies Primarily Operating in Jurisdictions That Do Not Provide the PCAOB with the Ability to Inspect Public Accounting Firms' (Washington DC, SEC, Release No 34-91089; File No SR-NASDAQ-2021-007, 9 February 2021) <<https://www.sec.gov/rules/sro/nasdaq/2021/34-91089.pdf>> accessed 10 August 2021.

157 SEC, 'Division of Enforcement 2019 Annual Report' (Washington DC, SEC, 2019) <<https://www.sec.gov/files/enforcement-annual-report-2019.pdf>> accessed 10 August 2021.

158 Michaels (n 15); Henny Sender, 'Luckin Coffee Investigated by Top Chinese Regulator' *Financial Times* (27 Apr 2020).

Significance of cross-border regulatory cooperation

Securities and audit enforcement agencies share a common mission to protect investors and foster market integrity.¹⁵⁹ The current obstacles restrict PCAOB's access to accounting information, which significantly impact cross-border information sharing. For the sake of effective oversight of audits, a paramount challenge hinges on whether Chinese regulators will cooperate with SEC. Although the Chinese law allows SAMR to cooperate with its foreign counterparts for joint inspection,¹⁶⁰ SEC's ability to enforce investor-protection laws is limited in China.

Viable transplantation of other models

Behind the HFCAA is the contradiction between China's need to safeguard its sovereignty and the USA's need to protect investor rights.¹⁶¹ China has insisted that the PCAOB follow the lead of the EU, which granted regulatory equivalency to China with respect to audit regulation.¹⁶² Regulatory equivalency allows European regulators to rely on the work of Chinese regulators as if it were their own. The PCAOB has not accepted the concept of regulatory equivalency, insisting instead on at least joint inspections, for instance, in Germany and France. There is valid concern that Chinese regulators do not have the wherewithal to inspect the ULCCs' audits,¹⁶³ which are often offshore companies. Chinese regulators would have neither expertise in US accounting and auditing rules nor adequate incentives to rigorously examine overseas listed companies.¹⁶⁴ China can learn from the cooperation models that France and Germany have each set up with the USA, and build a joint inspection mechanism led by China to effectively safeguard the interests of investors and the two countries.¹⁶⁵ Under the current decoupling trend, it is not viable for the PCAOB to follow the lead of the EU and negotiate regulatory equivalency under which the PCAOB would accept the work of Chinese regulators as its own. Neither could it be possible for the USA to amend the Sarbanes–Oxley Act to remove the requirement that the PCAOB inspect foreign accounting firms. HFCAA will strengthen the PCAOB's bargaining position with Chinese regulatory agencies.¹⁶⁶ It remains to be seen whether the

159 Clayton and others (n 2).

160 China Securities Law art 177 (1).

161 Lanxu Zhou, Xueqing Jiang and Shijia Ouyang, 'Joint Efforts Needed to Allay Doubts over U.S. Listing Bill' *China Daily* (27 May 2020).

162 Gillis (n 9).

163 Jonathan Barnett, 'Lessons from Luckin Coffee: The Underappreciated Risks of Variable Interest Entities' *CLS (Blue Sky Blog)*, 28 July 2020.

164 Richard H Macve, 'Alternative Lenses for Viewing How China Has Built Its Accounting and Auditing Profession' (2020) 11 (1) *Journal of Accounting in Emerging Economies* 49, 69.

165 PCAOB, 'PCAOB Enters into Cooperative Agreement with New German Auditor Oversight Body' (Washington DC, PCAOB, 24 August 2016) <<https://pcaobus.org/News/Releases/Pages/cooperative-agreement-German-AOB-082416.aspx>> accessed 10 August 2021; PCAOB, 'PCAOB Enters into Cooperative Agreement with French Audit Regulator' (Washington DC, PCAOB, 4 February 2013) <https://pcaobus.org/News/Releases/Pages/02042013_France.aspx> accessed 10 August 2021.

166 Shangjin Wei, 'America's Delisting Threat Could Pay Off' *Project Syndicate* (25 May 2020).

legislation could entail behavioural changes by the Chinese government, and allow PCAOB to audit report of ULCCs headquartered in China.

Would cooperation be only a concept in the deadlock?

The global cooperation seems to be a viable win-win strategy, while trade wars and zero-sum geopolitical competition undermine prosperity for all.¹⁶⁷ Although China needs foreign investors to revive its economy, it is unlikely to accept the US demand for full PCAOB access as it regards it as a sovereignty issue.¹⁶⁸ HFCAA forces ULCCs to submit to greater regulatory oversight or face delisting. It requires a 3-year period of non-compliance, and such a grace period gives Chinese and US regulators significant time to agree on how best to regulate ULCCs.¹⁶⁹ The tipping point is whether greater sanctions, like de-registration, should apply against the ULCCs since the PCAOB finds violations in China where it has only limited access. It is imperative for the USA and China to work in tandem to address the inspection and compliance issue in a market-oriented approach based on rule of law. There could be a possibility of settlement between the CSRC and SEC/PCAOB, allowing some degree of document sharing that could alleviate many of the latter's concerns. The CSL 2020 seeks to tighten corporate disclosure standards and makes it easier for investors to sue company directors.¹⁷⁰ Ideally, Chinese and US regulatory agencies may reach an agreement to eliminate or significantly lessen difficulties presently stifling the PCAOB's ability to inspect those ULCCs' audits.¹⁷¹

Overcome insurmountable barriers: is 'co-audit arrangement' a viable middle way?

The President's Working Group (PWG) on Financial Markets proposed a workaround for the ULCCs faced with the underlying challenge of conflicting laws.¹⁷² Imposing an additional PCAOB-registered audit firm report would have avoided Chinese accusations of extraterritoriality but ensured that the benefit of a US listing comes with further scrutiny.¹⁷³ The Chinese firms that do not comply with accounting standards risk being delisted from US stock exchanges as of the end of 2021.¹⁷⁴ They would be required to engage an affiliated US-member registered public accounting firm that would serve as the

167 Will Moreland, 'The Purpose of Multilateralism: A Framework for Democracies in a Geopolitically Competitive World' *Brookings* (September 2019).

168 Das (n 49).

169 HFCAA s2(i)(3)(A).

170 China Securities Law 2020 arts 94; 95.

171 Nicolas Grabar, Shuang Zhao and Robert Williams, 'SEC Roundtable: "Emerging Markets, Including China"' (Cambridge, Harvard Law School Forum on Corporate Governance, 10 August 2020) <<https://corpgov.law.harvard.edu/2020/08/10/sec-round-table-emerging-markets-including-china/>> accessed 10 August 2021.

172 President's Working Group on Financial Markets (n 119). <<https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf>> accessed 10 August 2021.

173 Georges Ugeux, 'The Backlash against Chinese-Company Listings on U.S. Exchanges Has a Long History' (*The CLS Blue Sky Blog*, 25 January 2021).

174 Jeff Mason, Andrea Shalal and Alexandra Alper, 'Chinese Firms that Fail US Accounting Standards to be Delisted as of 2022-Mnuchin' *Nasdaq* (10 August 2020).

principal auditor of the company's financials through a co-audit arrangement.¹⁷⁵ The US accounting firm will then submit its audit-of-the-audit to the PCAOB. The auditing commitment is ostensibly transferred from PCAOB to a private actor. A subsequent inquiry arises as to whether a US audit firm would be willing to accept liability as principal auditor through supervision. Even so, it remains unclear whether China would permit the co-audit process, and whether a US auditor performing a co-audit of the Chinese company would have access to the work papers. It is worth noting that the 'co-audit concept' has not been included in the HFCAA. Whether this workaround would be an effective solution for the ULCCs caught between conflicting laws remains to be seen. China would then likely adopt new countermeasures, if the co-audit alternative could be a way to get around Chinese regulations. There is also uncertainty as to whether the rules would apply to newly listing companies.

6. Conclusion

Audit quality and regulatory access to accounting reports play a vital role in maintaining the integrity of the US capital market. In terms of protecting the integrity of US exchanges and investors, higher levels of regulation may equate to increased compliance costs, but can have a positive impact on investor confidence. A foreign issuer must comply with host states' financial reporting obligations wherever it has operations. The current rules of the game fail to address capital raising by foreign issuers in premium markets sufficient to protect investors. In particular, an inquiry remains over how to heighten the scrutiny of US issuers based in China where it prevents full financial transparency. The PCAOB is authorized to oversee the audits of all US-listed public companies in order to protect the public interest by promoting informative, accurate and independent audit reports. However, it faces hurdles given significant legal obstacles preventing it from obtaining the information necessary in an inspection. China objects to the inspections as an impingement on its national sovereignty, and as a risk that national secrets might be disclosed. It is unequitable for ULCCs to benefit from US capital markets while evading PCAOB's inspections. The USA demonstrates a strong desire to take steps to reform the current legal and regulatory landscape. HFCAA is thus designed to protect US investors from the significant risks. HFCAA seeks to ensure that all companies on the US stock exchanges are subject to the same standards and regulations. It is centred on strengthening protections for investors and promoting the integrity of the US capital markets through improving disclosure and levelling the playing field. The Act would serve to resolve the longstanding conflict over the inability of the PCAOB to examine the work of Chinese auditors that report on the financial statements of US listed Chinese issuers. As an elephant in the room, a ULCC is to be delisted if its auditor could not be inspected by the PCAOB for three consecutive years.

175 Andrew Olmem, Christina Thomas and Jason Elder, 'Congress Passes the "Holding Foreign Companies Accountable Act"' *Harvard Law School Forum on Corporate Governance* (10 January 2021).

A broader decoupling of the USA and Chinese economies is underway, while HFCAA represents a significant escalation in tension and increasing friction between the two powers in capital markets. HFCAA could significantly alter the auditing ecology of capital markets, including revisions to exchange listing requirements in mainland China, Hong Kong and secondary listings on alternative exchanges. Meanwhile, it could also lead to massive delisting from the US exchanges. This requires unconventional wisdom for regulators from the USA and China to innovatively address the deadlock, so that stock volatility could be avoided at a global level.